

Message Text

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TO SECSTATE WASHDC PRIORITY 5005
TREASURY DEPT WASHDC PRIORITY
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DEPARTMENT PASS FEDERAL RESERVE BOARD; TREASURY FOR
DONALD E. SYVRUD, OASIA

E.O. 11652: GDS
TAGS: ECON, EFIN, UK
SUBJECT: AN OVERVIEW OF MAJOR FINANCIAL AND
ECONOMIC ASPECTS OF THE BUDGET

SUMMARY
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THE CHANCELLOR'S THIRTEENTH BUDGET SINCE 1974
(AND THE FIRST TO BE CARRIED LIVE ON RADIO) MUST BE
VIEWED IN THE CONTEXT OF (A) AN APPROACHING ELECTION,
(B) AN ATTEMPT TO MOVE THE U.K.'S SLUGGISH ECONOMY
INTO A HIGHER GROWTH PATTERN WITHOUT REKINDLING
INFLATION, AND (C) THE PRIME MINISTER'S GENUINE

DESIRE FOR A PROGRAM OF CONCERTED ACTION TO EMERGE FROM THE BONN SUMMIT IN JULY.

THE PERSONAL TAX CUTS AND OTHER STIMULATIVE ELEMENTS ANNOUNCED THIS AFTERNOON--INCLUDING TAX REDUCTIONS TO AID SMALL BUSINESS--ARE UNDERSTANDABLE IN THE ABOVE CONTEXT. WHILE TAKING CARE TO GIVE SOME TAX REDUCTION TO ALL TAXPAYERS, IT PRIMARILY REDUCES TAXES AT THE LOW END OF THE INCOME SCALE AND, COUPLED WITH INCREASES IN CHILD BENEFITS, TAKES A STEP TOWARDS REDUCING THE POVERTY TRAP. THIS SAID, IT DOES NOT PROVIDE AS MUCH STIMULATION AS CALLED FOR BY THE LEFT WING OF THE LABOR PARTY AND THE TUC. NOR DOES IT CUT THE HIGHER RATES OF TAX AS URGED BY THE CONSERVATIVES AND THE CBI. IT RAISES UNCERTAINTIES ON THE INTERNATIONAL MARKET. IN DECIDING TO BOOST THE ECONOMY BY AN INCREASE IN DISPOSABLE PERSONAL INCOME, THE BUDGET RUNS THE RISK--OR AT LEAST PUTS TO THE TEST--THE ABILITY OF U.K. INDUSTRY TO PRODUCE THE INCREASED GOODS AND SERVICES THAT WILL BE DEMANDED AS A RESULT. THE ALTERNATIVE IS INCREASED IMPORTS AND A WEAKER CURRENT BALANCE THAN OTHERWISE WOULD BE THE CASE. THE CHANCELLOR PRESUMABLY IS COUNTING ON NORTH SEA OIL PROCEEDS TO MASK SOME OF THE DETERIORATION. HOWEVER, HE RECOGNIZED WEAKNESS IN THE INDUSTRIAL STRUCTURE (AND THE CONFIDENTIAL

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LIMITS OF NORTH SEA RESOURCES) BY CITING THE NEED FOR GREATER OUTPUT AND COMPETITIVENESS IN PRICE, DESIGN, AND DELIVERY IF U.K. INDUSTRY, AND NOT ITS FOREIGN COMPETITORS, IS TO BENEFIT FROM THE STIMULUS AND JOB CREATION BEING OFFERED.

THE INCREASE IN MLR HAD AN IMMEDIATE POSITIVE IMPACT ON FOREIGN EXCHANGE MARKETS. THE CHANCELLOR'S STRESS ON HOLDING DOWN INFLATION, AND THE FACT THAT HE DID NOT MAKE TAX CUTS CONDITIONAL ON PAY RESTRAINT ALSO HAVE HAD A POSITIVE FIRST REACTION FROM MARKET COMMENTATORS.

THE PSBR TARGET OF 8.5 MILLION POUNDS AND THE 8 TO 12 PERCENT STERLING M3 TARGET FOR FY-78/79 APPEAR RESPECTABLE BUT AT THE UPPER END OF THE SAFETY MARGIN (GIVEN THE ROUGHLY 3 PERCENT GDP TARGET AND THE MINIMUM 7 PERCENT INFLATION RATE OF FY-78/79). THESE ARE THE UPPER RANGES OF WHAT THE FINANCIAL COMMUNITY CONSIDERS RESPONSIBLE. IN THESE RESPECTS, THE BUDGET WAS, IF ANYTHING, ORTHODOX. WHAT REMAINS TO BE SEEN IS IF THE MEASURES ANNOUNCED WILL SUCCEED

IN STIMULATING THE ECONOMY BY 3/4 PERCENT, THE
STRENGTH OF THE GOVERNMENT'S RESOLVE TO HOLD THE LINE
ON INFLATION, INCLUDING LIMITING INCREASES IN PUBLIC
SECTOR PAY, AND WHAT THE TRADE UNION RESPONSE WILL BE

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TO THE CHANCELLOR'S VEILED CALL FOR FURTHER PAY
RESTRAINT.

THE CHANCELLOR ANNOUNCED A FURTHER PREPAYMENT OF
1 BILLION DOLLARS TO THE IMF AND A 350 MILLION DOLLAR
U.K. GOVERNMENT BORROWING IN NEW YORK. THE GOVERNMENT'
POLICY IS NET DEBT REPAYMENT OVER THE NEXT SIX YEARS,
COUPLED WITH NEW BORROWING TO SPREAD THE EXISTING
MATURITY SCHEDULE, SO AS NOT FORCE THE GOVERNMENT TO
OTHERWISE RESTRICT DOMESTIC GROWTH.

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THE CHANCELLOR OF COURSE CITED THE MAJOR IMPROVEMENTS IN THE U.K. ECONOMY DURING THE PAST YEAR, BUT ALSO STRESSED THE NEED FOR CONCERTED INDUSTRIAL WORLD ACTION TO COUNTERACT THE CURRENT WORLD SLUMP. NO SINGLE NATION COULD DO THE JOB ON ITS OWN; HE SAW THIS BUDGET AS THE FIRST U.K. CONTRIBUTION TO THE JOINT EFFORTS. END SUMMARY.

1. TO A CERTAIN DEGREE, THE BUDGET PRESENTATION BEGAN A DAY EARLY WHEN THE PRIME MINISTER MADE A STATEMENT TO PARLIAMENT ON MONDAY, APRIL 10 (FULL TEXT ON PAGE 12 OF LONDON TIMES OF APRIL 11), SUMMARIZING HIS VIEWS OF THE COPENHAGEN MEETING AND CITING AGREEMENT ON STRATEGY IN FIVE BROAD AREAS-- "ECONOMIC AND MONETARY AFFAIRS, EMPLOYMENT, ENERGY, TRADE, AND RELATIONS WITH THE DEVELOPED WORLD--SIMILAR TO THOSE I RECENTLY SUGGESTED TO PRESIDENT CARTER, AS AREAS WHERE THE WORLD NEEDS TO TAKE COLLECTIVE ACTION." LATER, HE SAID THE BUDGET TO BE INTRODUCED BY THE CHANCELLOR WILL TAKE INTO ACCOUNT "THE NEED FOR CONCERTED AND MUTUALLY SUPPORTIVE ACTION..." IN A LATER REPLY TO A QUESTION, HE SAID HE WAS UNAWARE OF ANY PROPOSITION THAT "WE SHOULD REENTER THE CURRENCY SNAKE, BUT I HAVE EXPRESSED MY VIEW TO THE PRESIDENT THAT IF IT IS AT ALL POSSIBLE, IT IS FAR BETTER TO REGULATE THE CURRENCY MARKETS ON A WORLD BASIS INCLUDING THE DOLLAR, RATHER THAN EXCLUDING THE DOLLAR FROM CONSIDERATION" AND LATER REMARKED ON THE GREAT FORCES OF THE MARKET TODAY, ESPECIALLY THE EURODOLLAR AREA, AND HOPED "WE SHOULD NOT STAND HELPLESS IN THE FACE OF THESE GALES."

2. THE CHANCELLOR OMITTED DETAILED
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MATERIAL FROM HIS TEXT WHICH WOULD BE AVAILABLE LATER IN SUPPLEMENTARY DOCUMENTS. IN HIS INTRODUCTION HE LIMITED HIMSELF TO THE MAIN ELEMENTS OF THE ECONOMIC SITUATION. AFTER FOUR PAINFUL YEARS, THE CHANCELLOR NOTED THAT THE U.K. ECONOMY WAS IN MUCH BETTER BALANCE. THE CURRENT ACCOUNT WAS IN SURPLUS; THE FINANCIAL POSITION WAS IMPROVED. INFLATION AND INTEREST RATES HAVE FALLEN; MONEY SUPPLY IS UNDER

CONTROL; RESERVES ARE AT AN EXCEPTIONAL LEVEL; THERE HAS BEEN NEARLY A 5 PERCENT RISE IN LIVING STANDARDS SINCE THE FOURTH QUARTER OF 1977; THE LARGEST QUARTERLY RISE IN SIX YEARS. HOWEVER, GROWTH IN OUTPUT IS INADEQUATE AND UNEMPLOYMENT REMAINS INTOLERABLY HIGH. A FIRST PURPOSE OF THE BUDGET IS TO ENCOURAGE ECONOMIC ACTIVITY AND REDUCE UNEMPLOYMENT SIGNIFICANTLY.

3. HOWEVER, THE U.K. CANNOT ISOLATE ITSELF FROM THE REST OF THE WORLD. WORLD GROWTH IS SLUGGISH. THIS IS MADE WORSE BY THE OPEC SURPLUS AND THE OECD DEFICIT, BUT THE LATTER MASKS A LARGE INCREASE IN THE US DEFICIT AND IN THE JAPANESE SURPLUS. ONE REASON FOR THE DISPARITY IS THAT OTHER COUNTRIES HAVE BEEN SLOW TO FOLLOW THE EXPANSIONARY LEAD OF THE U.S. THESE IMBALANCES ARE AT THE ROOT OF THE CURRENCY DISORDER OF RECENT MONTHS AND A FURTHER THREAT TO WORLD GROWTH. NO SINGLE COUNTRY CAN LEAD THE WORLD OUT OF ITS DIFFICULTIES--OR EVEN SOLVE ITS OWN PROBLEMS. THIS IS WHY SEVEN INDUSTRIALIZED COUNTRIES HAVE AGREED ON A CONCERTED APPROACH TO THE PROBLEM OF LOW GROWTH, CURRENCY INSTABILITY, THE TREND TOWARDS PROTECTIONISM, OVERDEPENDENCY ON IMPORTED ENERGY, AND INADEQUATE FLOW OF STABLE LONG-TERM CAPITAL AND AID FROM THE SURPLUS COUNTRIES TO COUNTRIES IN DEFICIT IN THE MONTHS LEADING TO THE BONN SUMMIT. THIS BUDGET REPRESENTS A BRITISH CONTRIBUTION TOWARDS THE COMMON EFFORT AS WELL AS MEETING NATIONAL NEEDS.

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4. MOST OVERSEAS DEBT IS DUE FOR REPAYMENT IN 1979-1984. IT IS NOT SENSIBLE TO PAY OFF ALL THIS SOLELY FROM CURRENT ACCOUNT SURPLUSES OVER THE SIX

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OR SEVEN YEARS, ADDING TO PROBLEM OF WORLD CURRENT
ACCOUNT IMBALANCE AND RESTRICTING EXPANSION OF THE
BRITISH ECONOMY. THE GOVERNMENT'S AIM IS TO COMBINE
NET YEARLY REPAYMENT OF DEBT WITH NEW BORROWING TO
SPREAD THE MATURITIES. THE CHANCELLOR HAD EARLIER
ANNOUNCED A \$1 BILLION REPAYMENT TO THE IMF. ARRANGE-
MENTS FOR THIS PAYMENT HAVE RECENTLY BEEN COMPLETED.
A FURTHER \$1 BILLION WILL BE REPAID TO THE IMF DURING
THIS YEAR. SINCE LAST OCTOBER, THERE HAS BEEN REPAY-
MENT OF AN ADDITIONAL \$1 BILLION OF HMG DEBT TO THE
OVERSEAS PRIVATE SECTOR AND THERE WILL BE AN ADDITIONAL
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\$1 BILLION THROUGHOUT THIS YEAR MEETING NORMAL MATURI-
TIES. OFFSETTING THIS IS \$630 MILLION BORROWED SINCE
OCTOBER FROM THE EUROPEAN INVESTMENT BANK AND THE COAL
AND STEEL COMMUNITY. IN ADDITION, THE BRITISH GOVERN-
MENT IS FLOATING A \$350 MILLION BOND ISSUE IN NEW YORK
IN 7 AND 15 YEAR TRANCHES AT A TRIPLE A CREDIT RATING.
THIS WILL SPREAD THE BURDEN BACKWARDS AND FORWARDS
SO AS NOT TO UNDULY RESTRICT THE ECONOMY AND TO MAKE
A CONTRIBUTION TO WORLD GROWTH.

5. HEALY STRESSED THE IMPORTANCE OF THE STRENGTH
OF THE INDUSTRIAL BASE AND THE NEED FOR U.K. INDUSTRY
TO BE ABLE TO PRODUCE AND SELL GOODS RESULTING FROM

THE INCREASED STIMULATION OF THE ECONOMY. OTHERWISE, DEMAND WOULD BE SATISFIED BY IMPORTS AND CREATE JOBS ELSEWHERE; IN THIS SITUATION, DEMAND STIMULATION WOULD BE SELF-DEFEATING. A KEY TO GROWTH MUST LIE IN INDUSTRIAL PERFORMANCE AND MEETING INCREASED DEMAND WITH BRITISH GOODS. THE FUTURE OF THE U.K. ECONOMY IS IN THE HANDS OF THOSE WHO WORK IN BRITISH INDUSTRY. GREATER PRODUCTIVITY IS NEEDED TO CREATE THE APPROPRIATE ENVIRONMENT AND ECONOMIC CLIMATE. THROUGHOUT THE PRESENTATION, THE CHANCELLOR SOUNDED LIKE A CONSERVATIVE WITH A SMALL "C".

6. MONETARY POLICY WILL CONTINUE TO PLAY A CENTRAL ROLE. STERLING M3 GREW BY ONLY 1/2 PERCENT IN MARCH. THE FIGURE FOR FY-77/78 WILL BE JUST ABOVE THE 13 PERCENT TARGET RANGE. THIS OVERSHOOTING WAS DUE IN PART TO EXCEPTIONAL INFLUX OF FOREIGN CURRENCY, CORRECTED LAST OCTOBER BY ALLOWING THE POUND TO FLOAT UPWARDS. THE STERLING M3 TARGET RANGE FOR FY-78/79 WILL BE 8 TO 12 PERCENT. THE DCE LEVEL WILL BE 6 BILLION POUNDS. CONFIDENTIAL

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THE TARGET PROVIDES FOR LOWER INFLATION AND AN INCREASE IN ECONOMIC GROWTH WITH AMPLE ROOM FOR AN INCREASE IN BANK LENDING TO INDUSTRY. STERLING M3 WILL BE THE MAIN FOCUS. SIX-MONTH ROLLING TARGETS WILL BE ADOPTED TO ALLOW FOR REGULAR REASSESSMENT AND MODIFICATION. IF THE COUNTER-INFLATION POLICY DEVELOPS AS HOPED, A LOWER TARGET COULD BE ADOPTED IN THE AUTUMN.

7. BECAUSE SHORT-TERM INTEREST RATES HAD BECOME OUT OF LINE WITH U.S. AND EURO DOLLAR RATES, AND IN LIGHT OF RECENT DEVELOPMENTS IN EXCHANGE MARKETS, MLR WAS RAISED FROM 6-1/2 PERCENT TO 7-1/2 PERCENT (WHICH BROUGHT ABOUT AN INCREASE IN THE STERLING FROM ABOUT \$1.8750 TO \$1.8830 AND OTHERWISE HELPED MASK FOREIGN EXCHANGE MARKET REACTIONS TO THE BUDGET MEASURES.)

8. THE CHANCELLOR SEES INFLATION OF 7 PERCENT AT AN ANNUAL RATE BY SUMMER, BUT RISING BY AT LEAST ONE PERCENT BY MID-1979. NOTICEABLY ABSENT WAS ANY TARGET FOR AVERAGE EARNINGS DURING THE NEXT PAY PHASE. HOWEVER, THE TREASURY FORECAST ASSUMES A 6 TO 8 PERCENT INCREASE IN EARNINGS IN THE YEAR TO JULY 1979. COOPERATION FROM EMPLOYERS AND UNIONS WILL BE NEEDED TO KEEP INFLATION FALLING AND INDUSTRY COMPETITIVE. THE CHANCELLOR WILL START DISCUSSIONS WITH BOTH SIDES OF INDUSTRY ON POSSIBLE COUNTER-INFLATION POLICIES. A MODEST INCREASE IN EARNINGS WILL HELP INSURE THAT LIVING STANDARDS CONTINUE TO RISE OVER THE YEAR AHEAD

WITHOUT UNDULY INCREASING INDUSTRIAL COSTS, OF WHICH EARNINGS ARE A LARGE PART. THE INCREASES IN DISPOSABLE INCOME RESULTING FROM THE BUDGET SHOULD HELP TOWARDS THIS GOAL WHICH THE CHANCELLOR CONSIDERED THE CHIEF RECIPE FOR INDUSTRIAL SUCCESS AND THE ONLY MEANS OF REDUCING UNEMPLOYMENT.

9. IN THE CHANCELLOR'S OPINION, THE SIZE OF THE
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BUDGET STIMULUS, ROUGHLY 2.5 BILLION POUNDS IN A FULL YEAR, WILL ADD ABOUT 3/4 PERCENT TO GROWTH OF GDP IN THE NEXT 12 MONTHS WITHOUT REFUELING INFLATION OR OVER-

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STRAINING PRODUCTIVE CAPACITY. THE 8.5 BILLION POUND PSBR FOR FY-78/79 IS 5-1/4 PERCENT OF GDP. ALTHOUGH THE PSBR TO BE FINANCED WILL BE A GOOD DEAL HIGHER THAN 5.7 BILLION POUNDS ESTIMATED OUTTURN FOR FY-77/78, THE INCREASE SHOULD BE COUNTERBALANCED BY LESS NEED TO SELL GILTS TO OFFSET THE DOMESTIC EFFECTS OF FOREIGN CAPITAL INFLOWS. NO DIFFICULTY IS FORESEEN IN FINANCING THE FY-78/79 PSBR.

10. THE CHANCELLOR STRESSED THE IMPROVEMENT IN LIVING STANDARDS CURRENTLY BEING RECORDED AND THE NEED
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FOR MODERATION IN EARNINGS DURING THE COMING YEAR IF BRITAIN IS TO MAINTAIN THE BENEFITS THAT HAVE BEEN MADE THUS FAR, STRESSING THAT THIS BUDGET DOES NOT CALL FOR ANY SACRIFICES AND THAT REAL LIVING STANDARDS CAN RISE WITHOUT INCREASING INDUSTRIAL COSTS IF WAGE INCREASES REMAIN MODERATE.

11. SEPARATE MESSAGES SUMMARIZE (A) THE DETAILED ELEMENTS OF THE CHANCELLOR'S PUBLIC EXPENDITURE INCREASES AND TAX PROPOSALS AND (B) THE GOVERNMENT'S NEW ECONOMIC FORECAST.

12. ASIDE FROM THE INTERNATIONAL FINANCIAL ELEMENTS OF THE PACKAGE, THIS HAS BEEN THE MOST WIDELY LEAKED BUDGET IN U.K. HISTORY, WITH THE MAIN ELEMENTS GENERALLY WELL KNOWN IN ADVANCE. THIS BUDGET, HIGHLY POLITICAL IN TONE, GOES A LONG WAY TOWARD BUT DOES NOT COMPLETELY MEET THE DEMANDS OF THE TUC (FOR TAX REDUCTIONS) AND THE LIBERAL PARTY (FOR AID TO SMALL BUSINESS) BOTH OF WHOM WILL CLAIM SOME CREDIT FOR THE MEASURES. THE CHANCELLOR IS MAINTAINING AN ELEMENT OF CAUTION, WHILE GOING ABOUT AS FAR AS HE CAN IN PROVIDING STIMULUS WITHOUT UPSETTING CITY AND THE INTERNATIONAL FINANCIAL COMMUNITY. THE EMPHASIS REMAINS ON WAGE RESTRAINT, CONTROL OF INFLATION, AND IMPROVEMENT OF THE INDUSTRIAL BASE IN ORDER TO MEET FOREIGN COMPETITION. WHAT REMAINS TO BE SEEN IS WHETHER THIS CAN BE ACHIEVED WITHOUT A SHARP INCREASE IN IMPORTS MANUFACTURED GOODS (WHICH ARE EXPECTED TO RISE FASTER THAN EXPORTS OF THE SAME) AND WHETHER THE TRADE UNIONS WILL SHOW THE NECESSARY RESTRAINT TO KEEP INFLATION FROM BOUNCING BACK INTO DOUBLE DIGITS. THE BUDGET CAN IN NO WAY BE TERMED INNOVATIVE OR SURPRISING
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BUT THIS ITSELF WAS EXPECTED GIVEN THE POTENTIAL DIFFICULTIES THAT MAY ARISE IN THE CURRENT POLITICAL CLIMATE WHEN STEERING THE PROPOSALS THROUGH PARLIAMENT. FOR BACKGROUND, SEE LONDON 5353. IN MANY WAYS, INCLUDING THE LACK OF MAJOR SURPRISES,PERHAPS INHIBITION BY BEING BROADCAST, THIS WAS ONE OF THE CHANCELLOR'S DULLEST AND MOST MODERATE BUDGET PRESENTATIONS.

13. MRS. THATCHER, IN AN IMMEDIATE REJOINDER, STRESSED THE LABOR PARTY'S RECORD OF TAX INCREASES AND POOR ECONOMIC PERFORMANCE DURING THE PAST FOUR YEARS. SHE CORRECTLY CALLED THE TAX REDUCTIONS VERY MODERATE IN THIS CONTEXT, CITED THE CHANCELLOR'S FAILURE TO REDUCE THE STANDARD (34 PERCENT) RATE OF TAX, AND STRESSED THE INCREASE IN PSBR. BREWSTER

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